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THE U.S. TRADE DEFICIT: A MISLEADING ECONOMIC INDICATOR

by Murray Weidenbaum

Testimony before the
Senate Finance Committee
Washington, DC, June 11, 1998

The trade deficit is my favorite candidate for the most misleading indicator in our statistical tool kit. More often than not, bad news for the economy is good news for the trade deficit, and vice versa. In 1992 the economy was in recession and our trade deficit came down. The next year our economy revived, and the trade deficit rose.

More recently, our trade with South Korea furnishes a similar and more dramatic example of the relationship between trade and the overall economy. In 1996, the United States enjoyed a trade surplus with Korea (approximately \$330 million a month). Korea's economy was expanding more rapidly than ours and our exports to that nation were a third larger than our imports.

In 1997, however, their currency and stock market crashed, and their economy declined sharply. Korea got rid of its trade deficit with us overnight (we now have a trade deficit with them, over \$600 million in March 1998). Our imports are approximately the same as before, but our exports are only about one-half of their former level. All this happened without any change in trade policy. Trying now to reduce our imports from Korea would make it more difficult for that nation to return to normal.

I also believe that we pay too much attention to the much larger trade deficit with Japan. In good measure, it is a statistical artifact resulting from the fact that we have the largest population in the industrialized world. The average Japanese spends more on U.S. products (\$538 in 1996) than the average American spends on Japanese products (\$432 in 1996). But because we have a much larger population, our total exports to Japan are less than our imports from that country.

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Please do not misinterpret my position. I believe that the trade deficit is a misleading indicator of economic success. But we should not ignore it. When we look beyond the short-run gyrations of the trade balance and the business cycle, there is a more fundamental and longer-run problem that does involve the trade deficit. It is a symptom of a more basic economic imbalance.

Stripping away the economic jargon, Americans invest more than we save. How do we finance our vast array of new and expanded factories, offices, and laboratories so essential to economic growth? By importing foreign capital. What do we do with the foreign money? We buy their goods and services — and the result is a substantial trade deficit.

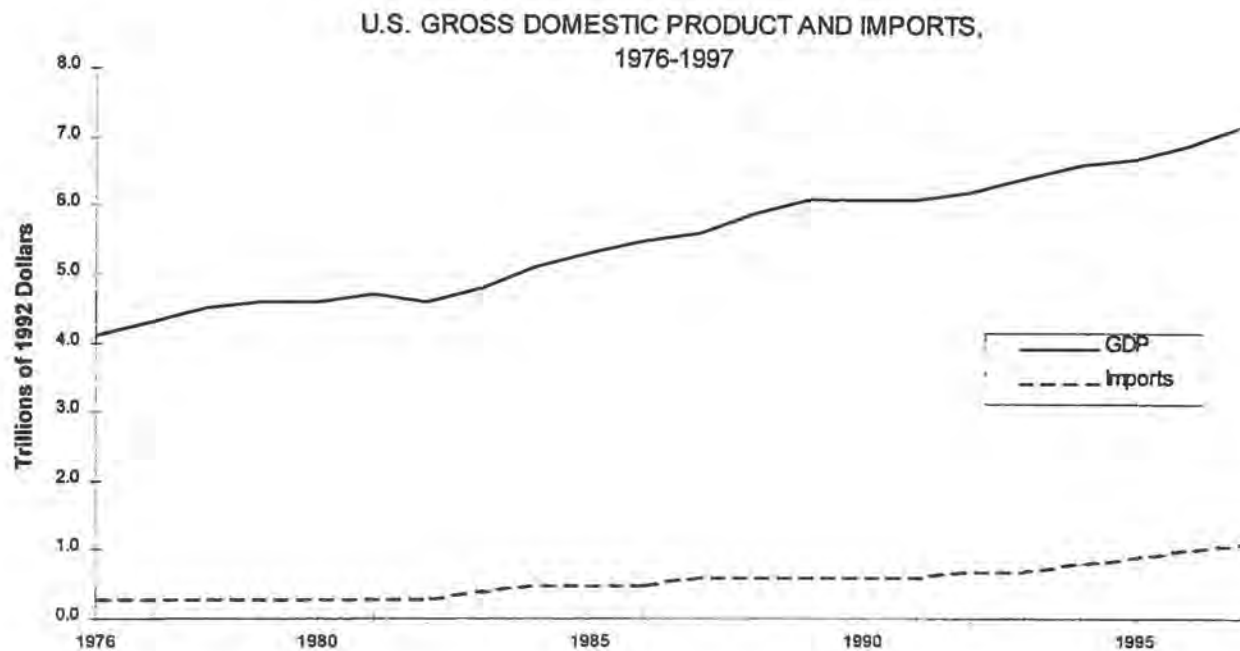
Yes, this explanation simplifies a complex economic reality, but I believe it is correct in its fundamentals. Moreover, this explanation points us in the right direction in terms of public policy: we can reduce the trade deficit in a constructive and sustainable manner — not by erecting barriers to imports or subsidizing exports — but by encouraging Americans to save more. That will provide at home more of the funds needed to finance economic growth.

Balancing the federal budget deficits is an important step because it eliminates a major source of dissaving. The Treasury is no longer a net borrower, so more private saving is now available to finance private investment. More can be done.

Congress has already embarked on an effort to increase saving through tax reform. The Roth IRAs are a good case in point. Personally, I would go all the way and defer all saving from taxation. This means deregulating the saving process so that Uncle Sam no longer tells Americans how much to save or the exact form in which to save.

It is also useful to see international trade in the context of the overall economy. Imports are dwarfed by the total output of goods and services (see chart). Moreover, the positive effects of imports tend to be overlooked. It is more than a matter of benefiting American consumers by providing greater product variety at lower prices — and these are important positive effects. The more basic and beneficial impact of imports is the role of foreign competition in spurring American companies to enhance their competitiveness by lowering costs, improving quality and, in other ways, enhancing productivity.

The trade deficits are also a reminder that economic progress can produce losers as well as winners,



SOURCE: U.S. Department of Commerce.

although not in equal proportions. The challenge to policymakers is how to help those who are hurt by progress without undermining that progress.

Any traveler beyond the borders of the continental United States quickly finds that our economy is the envy of the world. By any objective criteria, the United States is the pacesetter of our time. The citizens of other nations are trying to copy our economic system, business practices, culture, fashions, and freedom. They don't send their young people abroad to Tokyo University or Beijing University or Berlin University — but off to get an American MBA.

Concern for those not sharing in the general progress requires a constructive response. Pressures to “buy domestic” fly in the face of economic reality — given the fact that so many “foreign” products have U.S.-made components, and vice versa. We need to make the United States an even more attractive place to hire people and to do business. Tax reform and regulatory reform surely have important roles to play. The basic answer to low-priced import competition is not to “dumb-dumb” down jobs here but to raise the skill and performance level of Americans who have difficulty in finding good jobs.

It is a silly spectacle for Americans to quiver at the sight of international competition. The U.S.

economy is the strongest in the world and our long-term prospects are impressive. In a great many important industries, American firms are the global leaders. Our companies rank first in sales volume in aerospace and airlines, beverages and brokerage, chemicals, computers and cars, electronics and entertainment, paper products and pharmaceuticals, soap and scientific equipment.

There is a special reason for optimism. In the decades ahead, we will be benefiting from a huge upsurge of industrial research and development during the 1980s and 1990s. A key but quiet crossover occurred in the early 1980s — for the first time, company-sponsored R&D was larger than government-financed R&D. Primary reliance on private R&D has continued ever since, making more likely an accelerated future flow of new and improved civilian products and production processes in the United States. To envision what this might mean, we can reflect on how the fax machine and the Internet have altered customary work practices in little more than a decade.

To sum up this statement in a nutshell: we should not be so preoccupied with the statistical excess of imports over exports that we adopt policies that weaken the basic strength of our high-performance economy.